

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF CONSUMER AND COMMUNITY AFFAIRS

DATE: July 9, 2010
TO: Public Dockets R-1366; R-1367
FROM: DCCA Staff
SUBJECT: Meeting with NCLC and CRL Representatives

On April 7, 2010, representatives from the National Consumer Law Center and the Center for Responsible Lending met with Board staff and Governor Duke. The representatives were: Margot Saunders, Andrew Pizor, and Diane Thompson, National Consumer Law Center; and Kathleen Keest, Center for Responsible Lending. The representatives discussed their views on the Board's August 2009 proposed rules for closed-end mortgages and HELOCs. They also offered their views on the Board's review of the rules regarding the consumer's right to rescind. Their views are summarized in their agenda for the meeting, which is attached to this memo.

AGENDA
MEETING WITH GOV. DUKE
April 7, 2010, 2pm
Center for Responsible Lending and National Consumer Law Center

Introduction
Margot Saunders, NCLC

Extending the Provisions of the Higher-Cost HOEPA Rules to the Full Market Is Sound Market
Practice As Well As Sound Consumer Protection
Kathleen Keest, CRL

Why Rescission Matters
Andrew Pizor, NCLC

Threats to Rescission
Diane E. Thompson, NCLC

Make HELOC Rules More Like Closed-End
Margot Saunders, NCLC

MAKE HELOC RULES MORE LIKE CLOSED-END
April 7, 2010
Center for Responsible Lending and National Consumer Law Center

The rules governing Home Equity Lines of Credit (HELOCs) – should be the same as those governing closed-end home secured credit. Failure to do so undermines the Board's efforts to clean up the mortgage market by impeding consumer protection, defeating transparency, and introducing complexity instead of simplicity.

1. HELOC regulations must promote transparency, simplicity and consumer protection.

- Current proposal dispenses with pre-closing disclosures for HELOCs – making it impossible for consumers to ascertain real costs before closing.
- HELOC disclosures are based on whole different set of assumptions than closed-end – making it impossible to compare HELOCs and closed-end credit.
- Unlike new rules for closed-end loans, no substantive protections proposed for HELOCs.
- Instead of including all credit charges in the finance charge for HELOCs, the proposal excludes all charges from calculation of the APR—making APRs for HELOCs appear to be much lower than those for equivalent closed-end loans.

2. Proposal on HELOCs undermines the Board's efforts to promote consumer protection.

- The radical difference between disclosures for open- and closed-end home-secured credit will facilitate the development of predatory lending in the comparatively unregulated HELOC market.
- Consumers evaluating different forms of home secured credit will find it impossible to measure the costs of the open-end versus and closed-end credit.
- Excluding all credit charges from the HELOC APR will enable creditors to conceal costs in HELOCs while misleading consumers to rely on the deceptively lower APR.
- Hidden charges and more onerous terms will not be transparent in open-end credit and will be more exposed in closed-end credit, creating a market sweet spot for abusive terms in HELOCs.

3. The Board has noted that past market conditions have already made HELOCs an attractive form of credit for uses not directly related to purchasing, maintaining or improving the home securing the HELOC:

- HELOCs have been widely used, especially in the subprime market, as part of 80-20 transactions to purchase or refinance homes.
- Creditors have been willing to secure the homes at higher and higher loan-to-value ratios.
- Data shows that current HELOC lenders already have an appetite for risky home secured lending.
- The value of a "piggy-back" HELOC to create a high LTV loan provides little genuine collateral security to the creditor; its value instead is more to provide an *in terrorem* threat of foreclosure, making the product more susceptible to abuse.

4. Answers to Board's Questions about HELOCs:

- Q – Whether the existing substantive prohibitions applicable to closed-end loans should also be made applicable to HELOCs.

A – Yes.

(continued)

- Q – What proof is there that the problems already exist in the HELOC market to substantiate the need for equivalent protections.

A – There is little data available on HELOCs, but the absence of data is not the same as the absence of problems. The financial crisis suggests that too little attention to the actual examples of abuses was part of the reason that the regulators failed to act in a timely fashion.

- The more pertinent question is whether the rules will encourage proliferation of abuses, by widening the regulatory gap. Abuses migrate to the weakest link. The high-cost HELOC exclusion was exploited by Household in its refinance piggy-back loans which were among the abuses targeted in the states' action.

5. Board's approach to HELOC disclosures is based on flawed assumptions.

- Assumes that HELOC borrowers seek out HELOCs. The idea is that HELOC borrowers make deliberate decisions to use HELOCs because of their flexibility and that borrowers who draw the full amount of the line of credit do so because this is part of their "plan."
- While some borrowers in the prime market may actually make these choices, not so in the subprime market.
- In the subprime HELOC market, HELOCs are provided primarily as 80-20 financing deals. The lender finances 80% of the obligation with a closed-end mortgage and the remaining 20% with a HELOC. The transaction may be a home purchase or a refinance, but in either event the borrower is highly leveraged, with little or no equity cushion. The borrower rarely understands the terms of the deal before closing, or even that there are two separate loans, and is never made aware that one of the loans is a HELOC.
- Board's consumer testing was flawed – only selected consumers who had previously obtained or considered HELOCs.
- Board is treating HELOCs as an alternate form of a credit card, not an alternate form of a mortgage. These are drastically different products. Credit cards are unsecured. The non-payment of a credit card is unlikely to cause the loss of the family home. The non-payment of a loan secured by that home can cause that loss.

6. HELOCs should have the same substantive protections as closed-end mortgage loans.

- The duty to underwrite for ability to repay should apply to *all* mortgage loans secured by a borrower's principal residence, not just higher-cost loans.
- Require underwriting for all adjustable rate loans that determines the borrower's ability to pay the highest possible payments that may be required under the loan terms (counting both alternative amortization terms and the highest permissible interest rates).
- Prohibit foreclosure unless the HAMP loan modification analysis and procedure have been completed.

WHY RESCISSION MATTERS
April 7, 2010
Center for Responsible Lending and National Consumer Law Center

Definition of TILA Rescission: TILA provides the right to cancel a credit transaction secured by the borrower's principal dwelling for any reason, within three business days after consummation, or for up to three years after consummation where the creditor commits a material violation. 15 U.S.C. § 1635; Reg. Z §§ 226.15, 226.23.

The right to cancel protects homeowners from deceptive and predatory lending. TILA protects creditors by prohibiting rescission unless the violations are material and beyond often generous tolerances. Even after rescission, homeowners must repay the real proceeds of the loan to the creditor.

Rescission is the homeowner's single most important remedy for creditor misconduct. The right to rescind protects homeownership.

- A consumer's home is his most important and valuable asset—financially and socially.
- Unfair and deceptive lending practices threaten individual homeownership and our country's social and economic stability.

Only a remedy as powerful as rescission will compel compliance with the law in today's market:

- Most loans are sold on the secondary market or securitized, where they are effectively exempt from accountability for predatory practices—except for rescission. Rescission gives the secondary market incentive to police originators.
- Rescission is the most effective way to stop foreclosure on a predatory loan.
- Strict liability is necessary to make rescission an effective tool to compel compliance. Three of the most important factors in deterring violations are the swiftness, certainty and severity of punishment. Strict liability facilitates both swiftness and certainty by making the law easier to enforce and reducing ambiguity.
- The severity of rescission creates an economic incentive to comply—it makes compliance less expensive than noncompliance.

The three-day right to cancel a transaction gives homeowners the absolute right to cancel a mortgage transaction, at no cost. In doing so, it allows homeowners a chance to reconsider the consequences of encumbering their home, free of the pressure of a mortgage closing.

- Closings are often characterized by a tremendous number of complex legal documents, most of which the homeowner is encountering for the first time, including the promissory note and security instrument.
- Closings are often rushed, without sufficient time to carefully read all the documents, or compare final documents to initial disclosures.
- Closing agents may not be able to answer homeowners' questions at the closing.

(continued)

- The social dynamics of a closing often pressure the consumer to sign the documents presented, regardless of misgivings or reservations.
- A cooling-off period is a common tool of consumer protection across a wide array of transactions.
- When homeowners wake up the day after a closing and realize they cannot afford the loan, it is in everyone's the best interests—including the creditor's—to let the homeowners cancel those transactions before the creditor has disbursed any funds to the borrower.

The extended right to cancel a transaction permits homeowners to cancel a mortgage transaction up to three years after closing, if there are specified “material” violations. Few homeowners realize that they have been the victim of predatory lending until a threatened foreclosure forces them to seek legal help.

- Teaser rates can temporarily hide exploding ARMs or unconscionable terms.
- Improper and excessive finance charges prevent homeowners from refinancing out of predatory loans—unless they can use rescission to strip away those charges.
- Violations of the duty to underwrite for ability to repay become more apparent after payments come due and hybrid ARMs adjust
- The extended right to cancel makes lenders keep some skin in the game and encourages the secondary market to demand compliance with TILA.
- Without the extended right to cancel, originators would be able to conceal ticking time-bomb violations.

EXAMPLES OF WHY THE RIGHT TO RESCIND IS IMPORTANT

April 7, 2010

Center for Responsible Lending and National Consumer Law Center

Three-Day Right to Rescind

Jane Borrower¹ arranged to refinance the mortgage on her home in New York City. When she arrived at the closing, however, she discovered that the loan was far different from what she had originally been offered. The loan called for bi-weekly payments instead of monthly payments; the interest rate was wrong; and the lender had structured the loan in a manner that required her to pay the creditor for a grant she was receiving from the City. She told the closing attorney and the mortgage broker in attendance that she did not want the loan but they talked her into consummating the transaction anyway, telling her she had three days to cancel after the closing. She received all the mandatory TILA disclosures *except the Notice of Right to Cancel*.

Had the creditor given Ms. Borrower proper notice of her right to cancel, she would have known that she had to notify the creditor in writing of her intention to cancel the transaction. Instead, because she never received that information, she tried to cancel the loan within the three-day period by sending a text message to the mortgage broker. The broker talked her out of cancelling, and the loan ultimately ended-up in foreclosure. This case is still pending.

Extended Right of Rescission

Timothy Swafford² is a retired, illiterate laborer with a sixth grade education living in Martinsville, Indiana. In 2002 he was facing foreclosure on his family home, where he had lived since childhood. Needing a loan for \$52,000 to pay-off the existing mortgages, make some home repairs, and to pay other debts, he sought the advice of a mortgage broker. The broker arranged a foreclosure rescue scam in which the broker's brother bought Mr. Swafford's home for much less than it was worth and offered sell it back to him in a transaction that an Indiana court later found to be an unconscionable, undisclosed HOEPA loan that was an estimated 49% points and fees.

A year after the closing Mr. Swafford was able to rescind the transaction with help from an attorney because the creditor had failed to provide the mandatory TILA and HOEPA disclosures. The creditor refused to comply with his rescission letter, but a court ultimately enforced Mr. Swafford's extended right to rescind by ordering the creditor to deed the property back to Mr. Swafford and converting Mr. Swafford's tender obligation to an unsecured promissory note. The TILA right to rescind was critical in unwinding this transaction; without it, Mr. Swafford would likely have lost his home.

¹ All identifying information regarding this borrower has been withheld for reasons of confidentiality.

² This case study is a summary of *Hodges v. Swafford*, 863 N.E.2d 881 (Ind. App. 2007), *modified by* 868 N.E.2d 1179 (Ind. App. 2007).

EXAMPLES OF TENDER

April 7, 2010

Center for Responsible Lending and National Consumer Law Center

Case Study #1

Samuel R. Moore, Jr. and Carolyn A. Moore,¹ are disabled homeowners in Montague, Michigan. After falling victim to a foreclosure rescue scam involving an improperly disclosed HOEPA loan, an attorney helped them cancel the transaction using TILA's extended right to rescind. The amount the Moores were required to tender was calculated as follows:

\$221,962.27	Total loan amount (calculated based on amount paid to the Moores' mortgagee, taxes and insurance paid, and mortgage closing costs)
	Less
-\$25,237.85	Closing costs cancelled pursuant to Regulation Z
-\$2,000.00	Statutory damages awarded to Moores for creditor's failure to make the appropriate TILA disclosures
-\$2,000.00	Statutory damages awarded for creditor's failure to respond to Moores' letter cancelling the transaction
-\$6,706.66	Credit for payments made before the transaction was cancelled
\$186,017.76	Total Tender Amount Due

The court granted rescission of the Moores' transaction and modified the tender requirement by giving the Moores 120 days to pay the tender amount, at 7 percent interest, with interest-only payments due until the tender amount was paid.

¹ This case study is a summary of *Moore v. Cycon Enterprises, Inc.*, 2006 WL 2375477 (W.D. Mich. Aug. 16, 2006) and 2007 WL 475202 (W.D. Mich. Feb. 9, 2007).

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3. The Board has noted that past market conditions have already made HELOCs an attractive form of credit for uses not directly related to purchasing, maintaining or improving the home securing the HELOC:

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A – Yes.

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(continued)

- The social dynamics of a closing often pressure the consumer to sign the documents presented, regardless of misgivings or reservations.
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- When homeowners wake up the day after a closing and realize they cannot afford the loan, it is in everyone's the best interests—including the creditor's—to let the homeowners cancel those transactions before the creditor has disbursed any funds to the borrower.

The extended right to cancel a transaction permits homeowners to cancel a mortgage transaction up to three years after closing, if there are specified “material” violations. Few homeowners realize that they have been the victim of predatory lending until a threatened foreclosure forces them to seek legal help.

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EXAMPLES OF WHY THE RIGHT TO RESCIND IS IMPORTANT

April 7, 2010

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Three-Day Right to Rescind

Jane Borrower¹ arranged to refinance the mortgage on her home in New York City. When she arrived at the closing, however, she discovered that the loan was far different from what she had originally been offered. The loan called for bi-weekly payments instead of monthly payments; the interest rate was wrong; and the lender had structured the loan in a manner that required her to pay the creditor for a grant she was receiving from the City. She told the closing attorney and the mortgage broker in attendance that she did not want the loan but they talked her into consummating the transaction anyway, telling her she had three days to cancel after the closing. She received all the mandatory TILA disclosures *except the Notice of Right to Cancel*.

Had the creditor given Ms. Borrower proper notice of her right to cancel, she would have known that she had to notify the creditor in writing of her intention to cancel the transaction. Instead, because she never received that information, she tried to cancel the loan within the three-day period by sending a text message to the mortgage broker. The broker talked her out of cancelling, and the loan ultimately ended-up in foreclosure. This case is still pending.

Extended Right of Rescission

Timothy Swafford² is a retired, illiterate laborer with a sixth grade education living in Martinsville, Indiana. In 2002 he was facing foreclosure on his family home, where he had lived since childhood. Needing a loan for \$52,000 to pay-off the existing mortgages, make some home repairs, and to pay other debts, he sought the advice of a mortgage broker. The broker arranged a foreclosure rescue scam in which the broker's brother bought Mr. Swafford's home for much less than it was worth and offered sell it back to him in a transaction that an Indiana court later found to be an unconscionable, undisclosed HOEPA loan that was an estimated 49% points and fees.

A year after the closing Mr. Swafford was able to rescind the transaction with help from an attorney because the creditor had failed to provide the mandatory TILA and HOEPA disclosures. The creditor refused to comply with his rescission letter, but a court ultimately enforced Mr. Swafford's extended right to rescind by ordering the creditor to deed the property back to Mr. Swafford and converting Mr. Swafford's tender obligation to an unsecured promissory note. The TILA right to rescind was critical in unwinding this transaction; without it, Mr. Swafford would likely have lost his home.

¹ All identifying information regarding this borrower has been withheld for reasons of confidentiality.

² This case study is a summary of *Hodges v. Swafford*, 863 N.E.2d 881 (Ind. App. 2007), *modified by* 868 N.E.2d 1179 (Ind. App. 2007).

EXAMPLES OF TENDER

April 7, 2010

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Case Study #1

Samuel R. Moore, Jr. and Carolyn A. Moore,¹ are disabled homeowners in Montague, Michigan. After falling victim to a foreclosure rescue scam involving an improperly disclosed HOEPA loan, an attorney helped them cancel the transaction using TILA's extended right to rescind. The amount the Moores were required to tender was calculated as follows:

\$221,962.27	Total loan amount (calculated based on amount paid to the Moores' mortgagee, taxes and insurance paid, and mortgage closing costs)
	Less
-\$25,237.85	Closing costs cancelled pursuant to Regulation Z
-\$2,000.00	Statutory damages awarded to Moores for creditor's failure to make the appropriate TILA disclosures
-\$2,000.00	Statutory damages awarded for creditor's failure to respond to Moores' letter cancelling the transaction
-\$6,706.66	Credit for payments made before the transaction was cancelled
\$186,017.76	Total Tender Amount Due

The court granted rescission of the Moores' transaction and modified the tender requirement by giving the Moores 120 days to pay the tender amount, at 7 percent interest, with interest-only payments due until the tender amount was paid.

¹ This case study is a summary of *Moore v. Cycon Enterprises, Inc.*, 2006 WL 2375477 (W.D. Mich. Aug. 16, 2006) and 2007 WL 475202 (W.D. Mich. Feb. 9, 2007).

EXAMPLES OF TENDER

April 7, 2010

Center for Responsible Lending and National Consumer Law Center

Case Study #2

Timothy Swafford² is a retired, illiterate laborer with a sixth grade education living in Martinsville, Indiana. After a year of trying to make the payments on an undisclosed HOEPA loan that was an estimated 49% points and fees, Mr. Swafford exercised his extended right to cancel the loan, with an attorney's assistance. After extensive litigation a court finally established Mr. Swafford's tender obligation as follows:

\$43,884.36	Total loan amount (calculated on amount received by Swafford, paid to Swafford's creditors, and paid on taxes and insurance)
Less	
-\$26,922.24	Credit to Swafford for payments made to creditor before the transaction was cancelled.
-\$2,000.00	Statutory damages awarded to Swafford for creditor's failure to make the appropriate TILA disclosures
-\$2,000.00	Statutory damages awarded for creditor's failure to respond to Swafford's letter cancelling the transaction
\$12,962.12	Total Tender Amount Due

Mr. Swafford was subsequently able to reduce the \$12,962.12 tender amount to \$1,000 through the settlement of additional claims against the creditor.

² This case study is a summary of *Hodges v. Swafford*, 863 N.E.2d 881 (Ind. App. 2007), modified by 868 N.E.2d 1179 (Ind. App. 2007) with additional information provided by Mr. Swafford's attorneys.

EXAMPLES OF TENDER

April 7, 2010

Center for Responsible Lending and National Consumer Law Center

Case Study #3

Adrienne Howard³ is a disabled African American homeowner, whose sole income is disability payments. She was approached by a contractor who offered to make repairs to her home in exchange for payment of \$7,300. The contractor, who was later sued by the Illinois Attorney General for defrauding homeowners, arranged a \$17,000 loan, at 12.6% interest. The points and fees totaled 14 percent of the loan amount. Ms. Howard sought legal help after the contractor failed to perform any work. The tender amount in Ms. Howard's case was calculated as follows:

\$17,000	Total loan amount
	Less
-\$7,300	Amount paid to contractor
-\$2,022.22	Prepaid finance charge, including credit life insurance which was not voluntary and for which Ms. Howard was not eligible
-\$842.42	Other closing costs
-1835.36	Money not disbursed to Ms. Howard's other creditors
-\$2,000.00	Statutory damages for creditor's failure to make the appropriate TILA disclosures
-\$2,000.00	Statutory damages awarded for creditor's failure to respond to the letter cancelling the transaction
\$1,000	Total Tender Amount Due

Ms. Howard's exercise of rescission allowed her to retain ownership of her home, despite the contractor's fraud.

³ This case study is based on the facts in Ms. Howard's answer to the foreclosure complaint in *U.S. Bank, National Ass'n. v. Howard*, 00-CH-340 (St. Clair County, 20th Judicial Cir. Ill.). Diane Thompson represented Ms. Howard.